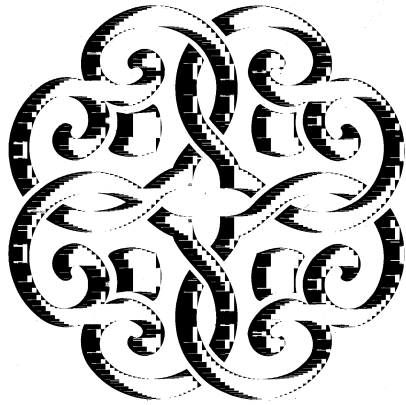


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The Neoliberal Model's Planned Role in Iraq's Economic Transition

Robert Looney

For many in the Bush Administration Iraq is now the test case for whether the US can create, through introducing a series of neoliberal economic reforms, a system of American style free market capitalism in the Arab world. The neoliberal model as applied to Iraq's economic transformation will entail a policy mix stressing a greater role for the market in the allocation of resources, a much-reduced role for the state, and increasing integration in the world economy. Although the model appears sound in terms of its theoretical construct and empirical validity, questions remain concerning its likely success in the Iraqi context.

Iraq has been blessed with abundant economic and human resources. It has the highest proven oil reserves in the world at around 112 billion barrels, after Saudi Arabia with 262 billion barrels. However, despite its wealth, Iraq has experienced continuous economic deterioration since 1980 and has become one of the region's least developed economies. A country that could have been a model of development for the Arab world, turned out to be a devastated case of economic decline, mismanagement, and massive corruption.¹

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1. Henry Azzam, "Iraq is Now One of the World's Least Developed Economies," *The Daily Star*, June 5, 2003, http://www.dailystar.com.lb/opinion/06_05_03_b.asp.

lies that depend on the state.⁵

While the Bush administration would like to use Iraq as a beacon of democracy in the Arab world, a potentially greater impact on the region might come through demonstrating in Iraq how a new economic approach could quickly revitalize even the most moribund economy. In fact, even before hostilities had broken out, interest was growing in Washington and in Arab capitals to find a way to spur growth in a region that over the past quarter century has lagged well behind other developing areas⁶. In short, the US is hoping to combine political reform and economic development in a way that could improve endemic problems in the region, such as youth unemployment, which Washington believes underlies terrorism.⁷

Academic institutes,⁸ private research organizations,⁹ and consulting companies¹⁰ have come forth with sound proposals and plans for reviving and invigorating the Iraqi economy. However, a paper from Washington's Heritage Foundation¹¹ most caught the attention of top Washington circles. In essence, this study lays out an argument for the complete neoliberalization of Iraq's internal markets, trade relations, and for the privatization of its industries, including oil.

In fact, the neoliberal view appears to have won sufficient supporters in Washington, for it to become the framework within which Iraq's economy will be structured over the next several years. The actual roadmap for the country's economic reforms is apparently¹² laid out in a (early May 2003) classified document titled "Moving the Iraqi Economy from Recovery to Sustainable Growth." Created by the Treasury Department and the US Agency for International Development (USAID) as a blueprint for prospective contractors it outlines a series of steps the Bush Administration wants to achieve over the next year in Iraq, steps that will launch the country as a test case for exporting the neoliberal economic model to the Middle East.¹³

In sum, for many in the Bush Administration, Iraq is now the test case for

5. Gary Becker, "What Iraq Needs Most is Pro-Market Reforms," *Business Week*, June 23, 2003, http://yahoo.businessweek.com/magazine/content/03_26/b3839026_mz007.htm.

6. Howard LaFranchi, "Using Iraq to Remake the Economy of the Mideast," *Christian Science Monitor*, April 28, 2003, <http://www.csmonitor.com/2003/0428/p01s04-usgn.html>.

7. LaFranchi, "Using Iraq."

8. Jan Svejnar, *A Strategy for the Economic Reconstruction and Development of Iraq* (Ann Arbor, Michigan: The William Davidson Institute, May 2003).

9. Valerie Maracel and John Mitchell, *Iraq's Oil Tomorrow* (London: The Royal Institute of International Affairs, April 2003); Frederick Barton and Bathsheba Crocker, *A Wiser Peace: An Action Strategy for a Post-Conflict Iraq* (Washington: CSIS, January 23, 2003); Norman Kurland, *Extending the Abraham Federation Model: A Just Third Way for Building Democracy for the Iraqi People* (Washington: Center for Social and Economic Justice, February 2003).

10. *Iraq – Economic Review and Prospects* (Kuwait City: Global Investment House, April 2003).

11. Ariel Cohen and Gerald P. O'Driscoll, *The Road to Economic Prosperity for a Post-Saddam Iraq* (Washington: Heritage Foundation, March 5, 2003).

12. Neil King, "Bush Officials Draft Broad Plan for Free-Market Economy in Iraq," *Wall Street Journal*, May 1, 2003, p. A1.

13. Eric Lursen, "Privatizing Iraq," *In These Times*, May 28, 2003, <http://www.globalpolicy.org/security/issues/iraq/after/2003/0528privatizing.htm>.

whether the US can create, within the Arab world, a system of American style free market capitalism. In a February address, President Bush spoke of "a new Arab charter that champions internal reform, greater political participation, economic openness and free trade." A new regime in Iraq, he said, "would serve as a dramatic and inspiring example of freedom for other nations in the region."¹⁴

The sections below examine the neoliberal model's approach to the restructuring deemed needed for Iraq's economic transformation. What are the model's main assumptions and components? How has it been applied to the Iraqi situation? Are the conditions in Iraq such that it has a good chance of success?

THE NEOLIBERAL MODEL

As it has evolved over time, the term "neoliberalism" is usually used by economists to refer to the economic policies pioneered by Chile in the 1970s. Subsequently, these reforms spread throughout most of Latin America in the 1980s and to other parts of the developing world in the late 1980s and early 1990s. In this sense, neoliberalism emphasizes a policy mix stressing a greater role for the market in the allocation of resources, a much-reduced role for the state, and increasing integration in the world economy. Unfortunately, in Latin America and many other nations, neoliberalism has come to represent the "evil of all evils" and to be held responsible for all problems by people who have no clear notion or definition of what neoliberalism really is.

The literature reflects these two differing views towards the neoliberal reforms. The first considers the structural reforms inspired by neoliberalism to be the quintessence of good economic policy while the other considers this model a disaster, involving excessively high costs, especially measured in terms of the suffering imposed on groups unable to protect themselves from market forces.

The intellectual foundations of modern neoliberalism stem largely from the writings during the 1950s and 1960s of Friedrich Hayek¹⁵ and Milton Friedman.¹⁶ In large part, Hayek and Friedman were responding to the emergence, and subsequent predominance, of Keynesianism in Western capitalist societies and to the socialism that evolved in the former Soviet Union, China, and many other nations following World War II.

In the eyes of the neoliberals the triumph of democracy and markets over authoritarianism and statist economies was combined with efforts to promote open economies and open policies stressing the necessity of thoroughgoing economic reforms supporting export-led industrialization policies.

For development economists, the rise of the East Asian economies vindicating the liberal prescriptions of market-oriented policies and participation in the world

14. King, "Bush Officials."

15. Friedrich Hayek, *The Road to Serfdom* (Chicago: University of Chicago Press, 1944); *The Fatal Conceit: The Errors of Socialism* (Chicago: University of Chicago Press, 1989).

16. Milton Friedman, *Capitalism and Freedom* (Chicago: University of Chicago Press, 1963); *Free To Choose a Personal Statement* (New York: Harvest Books, 1990).

economy made obsolete policies drawn from state-interventionist theories and protectionism. New growth trajectories stressing the importance of export-led development became widely accepted as an integral part of the neoliberal ideas inspiring economic and political changes in the world. Moreover, the downfall of communism in Eastern Europe and the collapse of the apartheid regime in South Africa can be depicted as the supreme examples of ill-fated attempts to sustain economic growth within a closed economy.

The neoliberal core is based on three important concepts: imperfect information, individual freedom, and the market.

Imperfect Information. Neoliberals contend that because individuals in general, and society as a whole have imperfect information about past and present developments and events, any strategy of attempting to plan or make policies is irrational and doomed to fail (Hayek). However, neoliberalism goes further, pointing out that any attempt to plan or construct a society which attempts to go beyond these natural restrictions is dangerous for the existing social order.

Individual Freedom. Neoliberalism is based on the freedom of, and private ownership by, individuals to seek to maximize their preferences. This apparently natural behavior is particularly important from an economic viewpoint because it leads to political freedom. Thus, individual economic freedom is the basis for any civilized society and is a direct response to totalitarianism or to any form of economic planning.

The Market. The market is the principal economic and social institution within which individuals adjust their preferences according to price signals, in spite of restriction in the available information. Hayek and Friedman are aware of the market's limitations, since perfect competition, individual freedom, and private ownership, as well as instantaneous price adjustments, depend on perfect information. The concept of "market" thus becomes a utopia and yet is dogmatically defended by neoliberals against any form of planning or state intervention.

Braer and Maloney¹⁷ note that while numerous economic policies have been encompassed under the rubric of neoliberalism, in actual practice it is often difficult to separate macroeconomic adjustment policies from liberalization measures. With this caveat in mind, they list the main components of neoliberalism as: (a) fiscal adjustment; (b) privatization; (c) decontrolling and/or adjusting prices; (d) decontrol of the financial sector; (e) trade liberalization; (f) incentives to foreign investments; (g) social security reform; (h) labor market reform.

Fiscal Adjustment. In most countries this has been achieved largely through reductions in subsidies and tax reforms.

Privatization. Since the world depression of the 1930s, many developing country governments had increased their presence in their economies through the founding of state enterprises in heavy industries, in the expansion of petroleum and other mineral resources, in public utilities, in banking, and even in some consumer goods in-

17. Werner Baer and William Maloney, "Neoliberalism and Income Distribution in Latin America," *World Development*, Vol. 25, No. 3 March 1997, pp 311-328.

dustries. Although this presence might have contributed to the industrialization and growth of some of these economies in the region, by the 1970s and 1980s many state enterprises had become loss-making operations due largely to inefficiency. Beginning at the end of the 1980s, many governments were convinced or persuaded by their creditors that in order to achieve a fiscal adjustment and to improve the efficiency of the economy a substantial portion of public sector enterprises should be privatized. With neoliberal reforms, privatization is usually accompanied by an increased emphasis on private property rights.

Decontrolling and/or adjusting prices. Many developing country governments have controlled process across a wide variety of products — public utilities, basic food products, some industrial products—as instruments of income distribution or as a way to decrease inflationary pressures. The net effect of these controls was to distort the allocation of resources, turn many firms in the affected sectors into loss-makers requiring government subsidies, and in some sectors, to discourage investments. The neoliberal agenda was either to free prices totally or to readjust prices of the controlled sectors to provide firms with a positive rate of return. In a similar spirit, the vast overvaluations of the exchange rate were to be avoided in favor of rates that would encourage integration with the rest of the world.

Decontrol of the Financial Sector. Controlled interest rates, often negative in real terms, allocative quotas for bank loans, and forced bank holdings of government debt discouraged savings and distorted the allocation of scarce capital resources. Ending “financial repression” implied greater market allocation of investment resources, and often the liberalization of controls on external capital flows.

Trade Liberalization. Many governments had retained the high levels of protection which were instituted as part of the promotion of their import substitution (ISI) programs of the 1950s and 1960s. In addition to the standard inefficiencies arising from tariffs and quotas, these regimes pushed countries away from developing in line with innate comparative advantage, shielded industries from healthy external competitive forces, and gave rise to “rent seeking” opportunities - corruption.

Incentives to Foreign Investments. After the 1982 Mexican debt default, most countries of the region experienced a drastic decline in private investment, a shortage of fiscal resources for the expansion of state enterprises, and the increased obsolescence of their industrial technology. Following Chile's lead many opened their entire economy to foreign investment, including such formerly closed sectors as telecommunications, petroleum expansion, power generation and distribution etc., frequently through debt-equity swaps

Social Security Reform. The traditional pay-as-you-go social security systems in Latin America were generally vastly underfunded and constituted a major, although hidden, component of government debt. Again, in 1980 Chile led the way to establishing private, competitive pension funds where workers held individualized accounts that reflected their accumulated contributions.

Labor Market Reform. The Labor protection system embodied in many Latin American constitutions is thought to have led to excessively rigid labor markets, ill-adapted to competition in a competitive, global economy. Under neoliberal reforms,

Chile's military government disbanded unions, and repealed minimum wage laws.

Neoliberals are firmly convinced that, with few exceptions, the set of measures referred to above is both a necessary and sufficient condition for growth and for equity. These views can be easily seen in the recent statements of Paul Bremer, the chief United States' administrator in Iraq:

"A free economy and a free people go hand in hand. History tells us that substantial and broadly held resources, protected by private property private rights, are the best protection of political freedom. Building such prosperity in Iraq will be a key measure of our success here."¹⁸

"In the long term we would like to see market prices brought into the economy...At this point it would be premature for me [sic] to lay down specific guidelines (for foreign investment) and it's a matter that, in the end, an Iraqi government would want to make a contribution to discussing."¹⁹

"Privatization is obviously something we have been giving a lot of thought to. When we sit down with the governing council... it is going to be on the table. The governing council will be able to make statements that could be seen as more binding and the trick will be to figure out how we do this. Everybody knows we cannot wait until there is an elected government to start economic reform."²⁰

"A fundamental component of this process will be to force state-owned enterprises to face hard budget constraints by reducing subsidies and special deals."

"Iraq will no doubt find that opening its borders to trade and investment will increase competitive pressure on its domestic firms and thereby raise productivity."²¹

"The nation's liberation would be incomplete if Iraqis were secure in their persons but not their property."²²

"The central lesson from past transitions is that the private sector must be encouraged to rapidly allocate resources to their most productive uses. In other transition economies, the switch from value-destroying public enterprises to value-creating private ones has been accomplished by stimulating

18. Scott Wilson, "Bremer Says Order Being Restored," *Los Angeles Times*, May 27, 2003, http://www.thedailycamera.com/bdc/middle_east/article/0,1713,BDC_10836_1991928,00.html.

19. "US to Organize New Credit Facility for Iraq's Foreign Trade," *Taipei Times*, May 28, 2003, <http://taipeitimes.com/News/worldbiz/archives/2003/05/28/2003053082>.

20. "Bremer Touts Privatization in Iraq," *Reuters News Service*, July 8, 2003, <http://www.chron.com/cs/CDA/ssistory.mpl/special/iraq/1985904>.

21. Edmund Andrews, "Overseer in Iraq Vows to Sell-Off Government-Owned Companies," *New York Times*, June 23, 2003, p. A13.

22. Bret Stephens, "Bremer Brings Reaganomics to Iraq," *The Jerusalem Post*, June 23, 2003, <http://freerepublic.com/focus/f-news/933654/posts>.

the growth of small and medium-sized private enterprises, which are able to create jobs quickly. The encouragement takes place by reducing the subsidies to state-owned firms and establishing a clear transparent commercial code. More generally a well established system of property rights must be established in order for the economy to grow."²³

In contrast neostructuralists,²⁴ institutionalists,²⁵ and other critics of the neoliberal agenda attribute poor economic performance to flaws in key markets i.e., rigidities, segmentation and gaps in those same factor markets, so that they question whether that set of measures will automatically result in growth and still less equity. They therefore call for state intervention to correct these critical flaws and claim that the notable success of the newly-industrialized Asian countries, in terms of both growth and equity, is due precisely to such interventions.

Ramos²⁶ suggests that another way of looking at the neoliberal reforms is to note that although in general terms the reforms make sense in the long run, there have been serious technical errors in their application. This has occurred because more often than not neoliberals assume markets have the capacity to adjust rapidly, automatically, and effectively to any kind of disturbance or policy change. If this flexibility is not present, many of the problems noted in the previous paragraph occur to an extent that often results in a dismantling of the neoliberal reforms. The other is that while recognizing there have often been costs in terms of deterioration in the distribution of income (and/or increase in poverty) stemming from neoliberal policies, advocates contend the reforms could be effected without regressive costs if applied judiciously and accompanied by additional measures to avoid or relieve distributive problems.

Summing up, neoliberalism is essentially about making trade easier. It is about freer movement of goods, resources, and enterprises in a bid always to find cheaper resources, to maximize profits and efficiency. The risks associated with this strategy are mainly short-term— increased unemployment, bankruptcies, increased concentration of income, all elements that can lead to political instability and backlash from groups which stand to lose from the introduction of neoliberal reforms.

NEOLIBERAL ECONOMIC POLICES CONSIDERED FOR IMPLEMENTATION IN IRAQ

As noted above, US postwar neoliberal strategy is apparently laid out in a USAID/US Treasury document, "Moving the Iraqi Economy From Recovery to Sustainable

23. Paul Bremer, "Operation Iraqi Prosperity," *Wall Street Journal*, June 20, 2003, <http://www.usembassy.ro/WF/500/03-06-20/eur505.htm>.

24. Andreas Steiner, "The CEPAL-Concept for Development in Latin America at the End of Our Century: Neostructuralism," <http://tiss.zdv.uni-tuebingen.de/webroot/sp/barrios/themeA3a.html>.

25. Moises Naim, "Fads and Fashion in Economic Reforms: Washington Consensus or Washington Confusion?" International Monetary Fund, October 26, 1999, <http://www.imf.org/external/pubs/ft/seminar/1999/reforms/Naim.htm>.

26. Joseph Ramos, "Neoliberal Structural Reforms in Latin America: The Current Situation," *CEPAL Review*, Vol. 62, August 1997, pp. 15-39.

Growth." While the document is classified, many of its key components have been leaked to the press, in particular to King of the Wall Street Journal. According to King²⁷ the main elements of the strategy include:

Privatize Iraq's Industries. Here, the US will attempt to build a consensus for industry privatization during the first year, after which the assets of the Iraqi public sector would be transferred to private ownership over a period of three years. The country did have some limited attempts at privatization in the 1980s, so the concept is not completely foreign to the population at large. The main controversy here is, obviously, the proposed privatization of the oil industry.

Modernize the Baghdad Stock Exchange. Here, the goal is to convert Iraq's rudimentary prewar stock market within a year into a world class exchange for trading the shares of newly privatized companies. Tasks would entail developing a centralized share registry as well as a new clearing and settlement system²⁸. Presumably, US officials working with AID contractors would write rules for membership in the exchange.

Reform the Central Bank. A new charter will be drafted to give the bank independence in pursuing monetary policy -- as opposed to the policy of underwriting government deficits under the Saddam regime. According to Faleh Daud Salman, Governor of the Iraqi Central Bank, "Independence will help us formulate economic policies that will contribute to encouraging activity in the country and making better use of its resources and revenue, as well as promoting growth²⁹". Contractors would help revamp the country's battered banking system by working out problem loans. The traditional Islamic money transfer system, Hawala³⁰, would be incorporated into the banking system.

Establish a New Currency. Beginning October 15, 2003 Iraqis will begin exchange of the notes, which bear the image of Saddam Husayn for new bills denominated between 50 and 25,000 dinars. This will end the dual currency system that has separated the Kurdish north from the rest of the country.³¹ It was not clear at the time of writing, however, the type of exchange regime the country will adopt. Since exchange rate stability is a key element in the neoliberal model, some type of fixed exchange rate is likely.³²

Provide Iraqi business with fresh credit. Initial plans are for extending as much as \$8 million in loans to small and medium sized Iraqi businesses within the first year.

27. King, "Bush Officials."

28. Karen Krebsbach, "After Saddam," *US Banker*, June 2003 Vol. 113, No. 6, p. 52.

29. "Iraqi Central Bank Chief Hails New-Found Independence," *Agence France Presse*, July 9, 2003.

30. Robert Looney, "Hawala: The Terrorist's Financial Mechanism," *Middle East Policy*, Vol. X No. 1, Spring 2003, pp. 164-167.

31. Richard A. Oppel Jr., "Banking and New Currency Planned for Iraq," *New York Times*, July 8, 2003, p. A14.

32. Robert Looney, "A Monetary/Exchange-Rate Strategy for the Reconstruction of Iraq," *Middle East Policy* (forthcoming Fall 2003).

Create a legal framework compatible with private ownership, production and distribution. This essentially involves creating a system of laws protecting private property contracts and all of the supporting infrastructure that is required by a modern market economy.

Rewrite the tax and tariff system. Here contractors would be designing a comprehensive income tax system and preparing regulations to impose a consumption tax. Presumably the tariff structure would be set quite low or even a tariff holiday for six months or so,³³ preparing the country for a free trade agreement with the US and eventual membership in the World Trade Organization.

Implementation of many of the neoliberal reforms is to be undertaken by BearingPoint of McLean Virginia. Under the contract³⁴ BearingPoint will be responsible for creating Iraq's budget, writing business laws, setting up tax collection, laying out trade and customs rules. It will also:

- Privatize state-owned enterprises by auctioning them off or issuing Iraqis shares in the enterprises.
- Reopen banks and jump-start the private sector by making small loans of \$100 to \$10,000.
- Wean Iraqis from the UN oil-for-food program, the main source of food for 60% of the population.
- Issue a new currency and set exchange rates.

The components noted above provide, at least in theory, a mutually complementary system that should be capable of providing the basis for rapid recovery and growth. One sequence might involve: state owned enterprises are sold or their shares distributed to the public. This provides capital to be sold on the Baghdad Stock Exchange. The consumption-based, rather than income-based tax system is supposed to encourage workers to spend less and save more, further expanding the capital markets. The stable currency reduces exchange rate risk, stimulating increased inflows of foreign, direct, and portfolio capital³⁵. Ideally, a virtuous cycle will be created in which a large financial burden is removed from the state, with the private sector playing a key role in the nation's capital formation.

In short, one of the main advantages of the neoliberal model is that it shifts a good deal of the costs for reconstruction and development to the private sector, thus reducing the direct burden placed on the United States and its coalition partners. Advocates contend that given the unlikelihood of Iraqi oil revenues being sufficient

33. Edmund L. Andrews, "After Years of Stagnation, Iraqi Industries are Falling to a Wave of Imports," *New York Times*, June 1, 2003, p. 1.

34. James Cox, "BearingPoint Gets Contested Iraq Contract," *USA Today*, July 21, 2003, http://www.usatoday.com/news/world/iraq/2003-07-21-iraq_x.htm.

35. Lursen, "Privatizing Iraq."

to cover these costs, there are no real alternatives to the neoliberal approach.³⁶

ECONOMIC FREEDOM

As the quotes above from Paul Bremer suggest, neoliberalism is closely associated with the concept of economic freedom. Following the Fraiser Institute's³⁷ conventions, the key ingredients of economic freedom are personal choice, voluntary exchange, freedom to compete and protection of person and property. Institutions and policies are consistent with economic freedom when they provide an infrastructure for voluntary exchange and protect individuals and their property from aggressors seeking to use violence, coercion, and fraud to seize things that do not belong to them. Legal and monetary arrangements are particularly important; governments promote economic freedom when they provide a legal structure and law-enforcement system that protects the property rights of owners and enforces contracts in an even-handed manner. They also enhance economic freedom when they facilitate access to sound money.³⁸

However, economic freedom also requires governments to refrain from many activities. They must refrain from actions that interfere with personal choice, voluntary exchange, and the freedom to enter and compete in labor and product markets. Economic freedom is reduced with taxes, government expenditures, and regulations are substituted for personal choice, voluntary exchange and market coordination. Restrictions that limit entry into occupations and business activities also retard economic freedom.

The Frasier Institute makes the concept of economic freedom operational through developing its Economic Freedom of the World (EFW) index. "We are confident that the Economic Freedom of the World (EFW) index is the best available and that it provides a reliable measure of cross-country differences in economic freedom using third party data to help insure objectivity"³⁹ The EFW itself is a composite of the degree of economic freedom present in five major areas:

- Size of government: Expenditures, Taxes, and Enterprises
- Legal Structure and Security of Property Rights
- Access to Sound Money
- Freedom to Exchange with Foreigners
- Regulation of Credit, Labor, and Business

One advantage of assigning numbers to the various dimensions of economic freedom is that it facilitates comparisons across countries. Countries receive a score

36. Robert Looney, "Bean Counting in Baghdad: Debt, Reparations, Reconstruction, and Resources," *Middle East Review of International Affairs* (forthcoming September 2003).

37. James Gwartney and Robert A Lawson, *Economic Freedom of the World: 2003* (Vancouver: Fraser Institute, 2003).

38. Gwartney, Lawson, *Economic Freedom of the World: 2003*, p. 3.

39. Gwartney, Lawson, *Economic Freedom of the World: 2003*, p. 4.

ranging from 0 – no freedom to 10 – the highest level attainable on the total index and each of its five main components. While this information is useful in and of itself, it also lends itself to the identification of empirical links with the real economy – does increased economic freedom facilitate higher rates of economic growth? Lower inflation? If so, are certain components of economic freedom more important than other components? For statistical reasons⁴⁰ several control variables were also used in the analysis: (1) the level of development – to what extent does the country's economic progress rather than economic freedom account for something like the growth in per capita income? and (2) whether or not the country was located in the Middle East – by the nature of being in the Middle East do countries have higher or lower rates of per capita income growth?

Using regression analysis,⁴¹ to test for statistically significant links between the main dimensions of economic freedom and key economic variable, produced a number of interesting results (Tables 1, 2, and 3), largely consistent with what the neoliberal model would predict.

Several of the more important findings suggest that:

Per Capita Income Growth. The growth in per capita income is negatively affected by being located in the Middle East, as well as being higher up on the development scale. This last variable is consistent with the neoclassical convergence theory (references) which posits lower income countries by having a theoretically higher rate of return on capital should be growing at a more rapid pace than countries at the higher end of the income scale. Lower income countries can further increase their income levels through improved legal structure and property rights. Somewhat surprisingly, however, deregulation may have a negative impact on growth, although this factor was only marginally significant.

Saving and Investment. Key macroeconomic indicators such as capital formation, foreign investment, and national savings are all positively affected by increased economic freedom, especially the freedom to exchange with foreigners. Improved legal structure and property rights result in higher levels of national savings. On the other hand, reduced government size and improvements in the legal structure and property rights reduces consumption – presumably by opening up profitable outlets for increased savings.

International Trade As predicted, increased economic freedom in the area of exchange, the ability to exchange with foreigners increases both imports and exports. In addition, deregulation in credit, labor, and business assists in expanding exports.

Inflation The rise in food prices and the overall consumer price index are both retarded by improved access to sound money, confirming the importance of central bank reforms and independence from political pressures.

Government Expenditures and Taxes. In the fiscal area, reducing the size of government would moderate the overall amount of resources controlled by the public sector. In particular, the amount of subsidies in the budget as well as the percentage of

40. To control for the level of development and any factors associated with the Middle East per se.

41. The complete set of results is available from the author upon request.

TABLE 1
Economic Freedom Results (2001)

Variable	Significant Factors (descending significance)	Factor Impacts
<u>Per Capita Income</u>		
(1) Per Capita GDP (purchasing power parity)	Development Level	
	Legal Structure/ Property Rights	+
(2) Growth Per Capita GDP	Development Level	-
	Middle East Country	-
	Legal Structure/Property Rights	+
	Regulation of Credit, Labor and Business	-
<u>Macroeconomic Indicators</u>		
(3) Gross Fixed Capital Formation (%GDP)	Freedom to Exchange With Foreigners	+
(4) Gross National Savings (%GDP)	Legal Structure/ Property Rights	+
(5) Foreign Direct Investment (%GDP)	Freedom to Exchange With Foreigners	+
(6) Personal Consumption (%GDP)	Freedom To Exchange With Foreigners	-
	Size of Government	+
	Middle East Country	-
	Legal Structure/Property Rights	-
<u>External Trade</u>		
(7) Imports Goods and Services (%GDP)	Freedom to Exchange With Foreigners	+
	Size of Government	+
	Level of Development	-
(8) Exports Goods and Services (%GDP)	Freedom to Exchange With Foreigners	+
	Regulation of Credit, Labor, Business	+
	Access to Sound Money	-
<u>Inflation</u>		
(9) Inflation (% Change in CPI)	Access to Sound Money	-
(10) Inflation (% Change in Food Prices)	Access to Sound Money	-

TABLE 2
Economic Freedom Results — Fiscal/Financial (2001)

Variable	Significant Factors (descending significance)	Factor Impacts
<u>Fiscal Measures</u>		
(1) Government Expenditure (%GDP)	Size of Government	-
	Freedom to Exchange With Foreigners	+
	Middle East Country	+
(2) Military Expenditures (%GDP)	Middle East Country	+
(3) Wages & Salaries (% Total Expenditures)	Size of Government	-
(4) Interest Payments (% Total Expenditures)	Middle East Country	+
	Size of Government	+
	Access to Sound Money	-
(5) Subsidies (% Total Expenditures)	Size of Government	-
	Middle East Country	-
	Development Level	+
(6) Tax Revenue (%GDP)	Size of Government	-
	Legal Structure/Property Rights	+
<u>Financial Indices</u>		
(7) Market Capitalization	Regulation of Credit, Labor, Business	+
Listed Companies (%GDP)	Development Level	+
(8) Liquid Liabilities (M3/GDP)	Legal Structure/ Property Rights	+

the budget allocated to wages and salaries – two components that have historically resulted in government deficits would decline with increased economic freedom in the public sector. Interestingly, increased size of government is associated with lower tax revenues – no doubt leading to even greater deficits in many cases.

Financial Development. In the financial area, and after controlling for the level of development, market capitalization of listed companies as a share of GDP would increase with reductions in regulation of credit, labor, and business. Financial intermediation, a key indicator of successful development would also expand with deeper reforms in the area of legal structure and property rights.

Diffusion of Technology. The spread of technology or more technologically sophisticated products is greatly enhanced with progress in expanding economic freedom. In most cases, the key element is improvements in legal structure and property rights.

TABLE 3

Economic Freedom Results — Technology Diffusion/Demographic (2001)

Variable	Significant Factors (descending significance)	Factor Impacts
<u>Technology Diffusion</u>		
(1) Telephone Mainlines (per 1000 people)	Legal Structure/Property Rights	+
	Development Level	+
(2) Personal Computers (per 1000 people)	Development Level	+
	Legal Structure/Property Rights	+
(3) Mobile Phones (per 1000 people)	Development Level	+
	Legal Structure/Property Rights	+
	Freedom to Exchange With Foreigners	+
(4) Services (%GDP)	Freedom to Exchange With Foreigners	+
	Legal Structure/Property Rights	+
	Size of Government	+
(5) Information and Communication Tech Expenditure (%GDP)	Legal Structure/Property Rights	+
	Regulation of Credit, Labor, Business	+
<u>Demographic</u>		
(6) Illiteracy Rate	Freedom to Exchange With Foreigners	-
	Legal Structure/Property Rights	-
(7) Urban Population Growth (annual %)	Legal Structure/Property Rights	-
	Freedom to Exchange With Foreigners	-
	Size of Government	+

Demographics. Finally, several key demographic indicators are affected by enhanced levels of economic freedom. In particular, improvements in the freedom to exchange with foreigners as well as an improved legal structure/property rights reduce the rate of illiteracy. The growth rate in the urban population is reduced somewhat with improved legal structure and property rights as well as the freedom to exchange with foreigners. On the other hand, reduced economic freedom associated with a larger government expands the rate of urban population growth, perhaps by encouraging rent seeking⁴² (corruption) in the seats of government.

In sum, the neoliberal model as viewed from the perspective of improvements in economic freedom is soundly based in empirical reality. Increased economic freedom is associated with improved indicators across a wide variety of economic indicators, improvements in which are critical for Iraq's recovery and eventual growth.

42. A.O. Krueger, "The Political Economy of the Rent-Seeking Society," *American Economic Review* Vol. 64 June 1974, pp. 291-303.

FACTORS AFFECTING THE SUCCESS OF THE NEOLIBERAL MODEL IN IRAQ

Although the neoliberal model appears sound, both in terms of its theoretical construct and empirical validity, there are still serious questions that need to be addressed in assessing the degree of success it is likely to have in Iraq. Here, several issues immediately arise. Will the model still provide the needed investment and efficiency gains if some of its main components are missing or are not fully implemented? Do the proper environmental conditions for success exist in Iraq?

Since the neoliberal model relies primarily on functioning markets and private sector initiative to shift resources where they are most profitable, it is essential that a stable environment exists within which realistic estimates of future prices, costs, rates of return can be made. An institutional infrastructure defined by supportive government institutions, laws, and regulations is also a key complementary component.

GENERAL ENVIRONMENTAL FACTORS

In terms of the post war reconstruction, US planners made two key assumptions that were not borne out. One was that the coalition authorities would find a fully functioning modern state, with government ministries, police forces, and public utilities in working order.⁴³ The second was that the resistance would end quickly. The absence of both of these key elements has undermined a key element of the neoliberal model - an environment that is conducive to private sector investment and risk taking.

There is no surprise that the biggest problem in post-war Iraq is a disastrous collapse in the moral order and a free-for-all of scavenging that can easily degenerate into looting and sheer banditry. A country once famous for its discipline has been converted by a generation of war and sanctions into a nation living in the shadows of criminality and despair.⁴⁴

On a more general level, a true market economy would be a big change for Iraq. In addition to state-run companies dominating the economy, a culture of entitlements pervades the country. Everyone is entitled to food rations. Gasoline prices are kept artificially low. Iraqis often offer fond memories of the generous cradle-to-grave welfare state provided before the economy was drained by three successive wars, beginning with the Iran-Iraq conflict of the 1980s.⁴⁵ In short, there is no culture of

43. Mark Fineman, Robin Wright, and Doyle McManus, "Washington's Battle Plan: Preparing For War, Stumbling to Peace; US is Paying the Price for Missteps Made on Iraq," *Los Angeles Times*, July 18, 2003, p. A1.

44. "Special Report Iraq: Iraq's Last Chance," *Middle East Economic Digest Weekly Special Report*, June 20, 2003, p. 44 (LexisNexis).

45. Mike Dorning, "Bremer Sets a Goal of Iraqi Free Market: Western-Style Economy Favored as Catalyst, for Change in Region," *Chicago Tribune*, May 27, 2003 <http://www.sunspot.net/news/nationworld/iraq/bal-te.iraq27may27,0,5965218.story?coll=bal-iraq-headlines>.

competition and free markets. This factor is quite relevant for Iraq because of the pattern of recovery of the transition economies of Central and Eastern Europe - those with the longest isolation from capitalist markets have been the slowest in revitalizing their economies.⁴⁶

IMPLEMENTATION FACTORS

A critical factor in market liberalization programs is the proper sequencing of reforms. Given the reality that everything cannot be done at once, which reforms are initially best, and what should follow for maximum effectiveness?

Tariff Reductions. Because it was probably the easiest to implement, one of the first neoliberal reforms undertaken was to reduce tariffs, allowing imports to come into the country at low world prices. Normally this action is beneficial, because it helps dampen inflationary pressures. The risk is that it may undermine the viability of existing private and state companies. Andrews (June 1, 2003) finds this phenomena in Iraq resulting in the country being:⁴⁷

transformed from one of the world's most isolated economies into a huge new free-trade zone. While goods simply unavailable or unaffordable before are flowing into the country there is a downside. Iraqi manufacturers, which employed more than one tenth of all workers before the war, are almost powerless to match the new competition. Their equipment is badly outdated and they lack marketing skills to compete with foreign goods. The free-market shocks are even bigger for the country's state owned industrial companies, which produce everything from packaged goods to electrical equipment and employ more than 100,000 people.

Privatization. Auctioning state-owned industries early – say late 2003, would amount to selling at a market bottom, as Iraqi assets are unlikely ever to be worth less than at that time. At the same time, Iraqis are unlikely ever to be as poor. So unless restrictions are put in place (reducing the revenues from privatization), state-owned companies will likely end up in foreign hands.⁴⁸

Social Security-Pensions. Social security and pension reform is usually a key element in neoliberal programs, yet there is not much mention of it in the Iraqi context. The usual case is for state-sponsored retirement programs to be converted into individual accounts in a way similar to US citizens' 401(k) plans to which work-

46. Oleh Havrylyshyn and Thomas Wolf, "Determinants of Growth in Transition Countries," *Finance & Development*, Vol. 36, No. 2 June 1999, <http://www.imf.org/external/pubs/ft/fandd/1999/06/havrylys.htm>.

47. Edmund L. Andrews, "After Years of Stagnation, Iraqi Industries are Falling to a Wave of Imports," *New York Times*, June 1, 2003, p. 1.

48. Jeremy Kahn, "Making Iraq Safe for Capitalism: Can a US Treasury Team Build a Free-Market Economy in a War-Torn Land," *Fortune*, June 23, 2003, <http://www.fortune.com/fortune/articles/0,15114,460336,00.html>.

ers contribute to fund their retirements. In addition to providing for retirement, these programs are intended to increase savings and provide a stimulus for shares on local stock markets. It's unclear how the absence of these plans will retard the growth in private savings and the development of the Baghdad Stock Exchange.

POLITICAL FACTORS

The neoliberal reforms are a rather extreme solution to the country's problems. The neoliberal model is a distinctly Western approach to organizing economic activity. While many, but certainly not all, economists applaud the approach, those in other disciplines (and politicians) are extremely skeptical of its merits. It is a fairly high risk strategy in the sense that most of the costs of implementation are borne up front in the form of lost output and jobs as the restructuring and transformation process occurs. The benefits of the reforms usually do not begin to be significant for several years.

The model has also fallen somewhat into disrepute in the last several years, especially after the crisis in a number of Latin American countries that had adopted it in the late 1980s and early 1990s. The literature is replete with examples attributing (rightly or wrongly) a whole set of problems stemming from the model's implementation: (1) increased concentration of wealth in the hands of the very rich; (2) increased unemployment and underemployment; (3) wages that remain low for those who still have jobs; (4) decreased power of trade unions under the pressure of economic globalization; (5) increased crime as more people become economically marginalized; (6) increased numbers of police and prisons to combat the increase in crime; (7) increased homelessness and street begging; (8) an erosion of civil liberties; (9) rural depopulation as small farmers are put out of business by corporate agribusiness which, with free trade can take full advantage of its economies of scale; (10) armed resistance by traditional cultures put under economic siege; (11) increased immigration to more economically developed countries by those who no longer have land to work and/or cannot find work in the cities; (12) an increasingly irrelevant political system that is unable and/or unwilling to start a genuine, democratic debate because it is controlled by interlocking corporate interests that have the most to gain from the status quo; (13) an alarming decrease in social solidarity.

Given the neoliberal model's likely criticism by many Iraqi groups, its implementation will require broad based popular consensus and a leadership that is able to articulate the longer term benefits of the program. This does not appear to be occurring in Iraq. As bin Talal notes: "Iraqis are rightly cautious of accepting solutions imposed on them by third parties that have their own economic or regional interests."⁴⁹ It does not bode well for the successful introduction of neoliberal reforms into Iraq.

49. Hassan bin Talal, "Seeking Iraq's Future by Looking at Its Past," *New York Times*, July 18, 2003, p. A17.

CONCLUSIONS

There is no alternative (TINA) was an oft-repeated expression of Margaret Thatcher's, used to dismiss any plausible alternatives to her brand of hard-nosed neoliberalism⁵⁰. As the British economy has subsequently proved, things are never this black and white.

The big debates will be between those in Washington who want to press ahead with a dogmatic neoliberal approach and those in the field who see the necessity, often for political reasons, to go step-by step, acknowledging a large amount of uncertainty about what institutional changes are necessary or even desired by the Iraqis.⁵¹ On the Iraqi side, advocates for the adoption of an Islamic economic⁵² system will be more and more vocal if the neoliberal reforms do not show quick dividends. Groups that are more moderate no doubt will push for various "Third Way" systems, revolving around retaining state ownership of the oil sector, and the disbursement of its revenues to the population at large.⁵³

50. Ronaldo Munck, "Neoliberalism, Necessitarianism and Alternatives in Latin America: There is No Alternative (TINA)?" *Third World Quarterly*, Vol. 24, No. 3 (June 2003), pp. 495-512.

51. E.J. Dionne Jr., "Bremer's Iraq: Pragmatism vs. Dogma," *Washington Post*, July 15, 2003, <http://www.washingtonpost.com/wp-dyn/articles/A56521-2003Jul14.html>.

52. David Brown, "Some Iraqis Envision an Islamic, Rather Than Western Style Economy in their Country," *Marketplace*, May 30, 2003, http://www.marketplace.org/shows/2003/05/30_mpp.html.

53. Kurland, *Extending the Abraham Federation Model: A Just Third Way for Building Democracy for the Iraqi People*.